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C O N F I D E N T I A L CARACAS 001338

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HQ SOUTHCOM ALSO FOR POLAD
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TAGS: ECON EFIN VE
SUBJECT: BRV NOT IMMUNE TO INTERNATIONAL FINANCIAL TURMOIL

REF: A. 2007 CARACAS 1292
¶B. CARACAS 930
¶C. 2007 CARACAS 2186

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: The Bolivarian Republic of Venezuelan (BRV) has not escaped recent problems in the US financial sector unscathed. The government holds about USD 300 million and private banks an additional USD 400 million in structured debt notes issued by the bankrupt Lehman Brothers. The firm's bankruptcy has reduced the value of these assets, but the losses should have little impact on the Venezuelan economy or government finances. Local analysts estimate that the BRV could hold up to USD 50 billion in foreign currency assets on top of its official reserves. Of greater concern to the BRV will be the increased borrowing costs resulting from market turmoil and the downward pressure that worries about the outlook for the world economy could put on oil prices. End Summary.

¶2. (U) While President Hugo Chavez has publicly reveled in the problems affecting the US financial sector, the BRV has not been unscathed by the turmoil roiling international financial markets, most notably the September 14 bankruptcy of the investment bank Lehman Brothers. Chavez on September 16 told reporters that the problems at Lehman Brothers would have little effect on the Venezuelan economy and accused the firm of unduly criticizing the BRV's economic policies rather than examining its own books. However, press stories the same day indicated that about USD 300 million in BRV assets and about USD 400 million of Venezuelan banking sector assets were tied to Lehman Brothers.

¶3. (SBU) The BRV assets in question are held in the National Development Fund (FONDEN). They are notes structured by Lehman Brothers and backed by a mixture of emerging market sovereign bonds purchased by the BRV in 2006 or earlier (ref A). The Ministry of Finance has admitted to holding these notes and announced that it plans to review its options to minimize losses. The BRV may have to sell these instruments at as much as a 75 percent discount, according to local press reports, but this estimate probably exaggerates the impact the problems at Lehman Brothers will have on the government's finances because the notes at risk lost much of their value soon after their purchase. (NOTE: The potential losses from

these notes are also small relative to total public sector

assets. Local analysts estimate that FONDEN currently holds as much as USD 20 billion in assets itself, and the BRV could hold up to a total of USD 50 billion in foreign currency assets across multiple funds in addition to its official reserves. END NOTE)

¶4. (C) The $400 million in banking sector assets exposed to the Lehman Brothers bankruptcy are made up of the "other structured notes" that banks had been using to circumvent a regulatory ceiling on foreign currency assets (ref B). While the problems at Lehman Brothers have certainly made these assets riskier for the banks holding them, it does not appear that problems in the US financial sector will significantly increase losses for Venezuelan banks. Asdrubal Oliveros (PROTECT), Director of the economic consulting firm Ecoanalitica, told Econoffs September 22 that Venezuelan banks had sold most of their notes issued by Lehman Brothers prior to its bankruptcy and that the notes still outstanding were held at two small banks who could lose all but 25 percent of their initial investments. Jesus Bianco (PROTECT), Chief Economist for the Venezuelan Banking Association, told Econoffs September 16 that the notes tied to Lehman Brothers, if held to maturity, would likely be respected because they were backed by contracts and tied to underlying assets.

¶5. (C) More troubling for the BRV is the effect that the problems on Wall Street will have on emerging market debt as a whole. Distress in financial markets has increased risk aversion and made investors less willing to hold emerging market bonds. Spreads on Venezuelan sovereign debt increased by about 250 basis points following the announcement of Lehman Brothers' bankruptcy and Merrill Lynch's acquisition by Bank of America. A shift toward safer assets will probably increase the cost of the BRV's strategy of issuing dollar-denominated debt (or buying and reselling Argentine debt) to limit liquidity growth and control the parallel exchange rate (ref C). Borrowing costs will probably rise further as Lehman Brothers and other investment banks who had been acting as counterparties and purchasing Venezuelan bonds in secondary markets exit the market. Contacts at one of Venezuela's largest brokerages Econoinvest (PROTECT) told Econoffs September 16 that Lehman Brothers had been a major purchaser of Venezuelan and other emerging market issues. They expected the firm's bankruptcy not only to shrink the market for emerging market debt, but to increase debt spreads as well when the firm sells off its assets. The BRV could also see some of its assets erode in value as prices of emerging market bonds fall. In addition to the notes tied to Lehman Brothers, the BRV holds as much as USD 700 million in other notes made up of emerging market debt in FONDEN that would be vulnerable to such a price decline.

¶6. (SBU) Comment: BRV and banking sector ties to Lehman Brothers have generated headlines but do not appear to pose a major risk to Venezuela. Losses resulting from the latest round of financial turmoil do not appear to be significantly larger than those already expected. Nevertheless, the BRV will feel the effects of the problems in financial markets through increased borrowing costs should it attempt to issue new sovereign debt. The most significant risk for the BRV is that problems at US financial firms could greatly damage its fiscal position if concerns about the outlook for the world economy continue to push down oil prices (septel). The BRV will probably face a much more difficult external environment going forward, which will limit its margin for error in the administration of oil revenues, handling of public sector assets, and management of external debt.
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